WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

THE MODIFIED LIFO METHOD: SEC STAFF INTERPRETS RULE 203(b)(3) OF REGULATION SHO REGARDING AGING FAILURES TO DELIVER, NEW FREQUENTLY ASKED QUESTION 5.8

In 2004, the Securities and Exchange Commission ("SEC" or "Commission") adopted Regulation SHO under the Securities Exchange Act of 1934 ("Exchange Act") to provide a framework for the regulation of short sales in securities.[1] Regulation SHO, which is comprised of SEC Rules 200, 202T, and 203, includes "locate" and delivery requirements, modification of the definition of ownership for short sale purposes, clarification of the requirements for determining a seller's net aggregate position, and new order-marking requirements.

Regulation SHO imposes additional delivery requirements on broker-dealers for securities in which a substantial number of failures to deliver occur. Rule 203(b)(3) provides that if a participant[2] of a registered clearing agency[3] has a failure to deliver position in a threshold security[4] that persists for 13 consecutive settlement days,[5] the participant must take action at the end of the 13th day or the beginning of the 14th day to close out the fail to deliver position.[6] One of the more important open issues concerning the operation of Regulation SHO since its adoption has been how to determine the aging of a participant's fail to deliver position under the Rule 203(b)(3) delivery requirement when the participant's end-of-day settlement position fluctuates over the course of time. This question has significant implications for a participant's compliance and operations functions and for SEC and SRO examination and enforcement activities.

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1 Short Sales, Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 ("Adopting Release"). Regulation SHO is codified at 12 CFR 242.200-203. For a discussion of Regulation SHO, *see*, Willkie Farr & Gallagher LLP Client Memorandum, "SEC Adopts Regulation SHO Governing Short Sales" (Aug. 5, 2004) available at http://www.willkie.com/firm/pubs.aspx; *see also*, Aaron Lucchetti & Kara Scannell, *Despite SEC Rules, a Small Amount of Naked Short Selling Appears to Persist*, WALL ST. J., Apr. 13, 2006, at C1 ("WSJ Article").

2 "Participant" is defined in Section 3(a)(23)(A) of the Exchange Act, 15 USC 78c(a)(23)(A).

3 "Registered clearing agency" is defined in Rule 203(c)(3) of Regulation SHO, 17 CFR 242.203(c)(3) (2006). The relevant clearing agency for purposes of Rule 203(b)(3) is the National Securities Clearing Corporation ("NSCC").

4 "Threshold security" is defined in Rule 203(c)(6) as any equity security of a reporting issuer where, for five consecutive settlement days, there are aggregate fails to deliver at a registered clearing agency of at least 10,000 shares and the aggregate fails to deliver are also equal to at least 0.5% of the issuer's total shares outstanding, and such security is included on a list disseminated by a self-regulatory organization ("SRO"). A list of such threshold securities is published daily by the SRO on which the security is listed or for which the SRO bears primary surveillance responsibility. A security will be removed from the list if it does not exceed the specified level of fails for five consecutive settlement days.

5 "Settlement day" is defined in Rule 203(c)(5) of Regulation SHO, 17 CFR 242.203(c)(5) (2006).

6 17 C.F.R. 242.203(b)(3) (2006).

After the adoption of Regulation SHO, the Commission's Division of Market Regulation ("Division" or "staff") issued *Responses to Frequently Asked Questions Concerning Regulation SHO* ("FAQ") to provide guidance on the operation and application of Regulation SHO.[7] The FAQ is occasionally supplemented by the staff. On March 17, 2006, the staff added new Question 5.8 to the FAQ to address the open question in Regulation SHO of how to determine the aging of a participant's fail to deliver position under Rule 203(b)(3). New FAQ 5.8 seeks to do two things: describe and explain a process for aging fails; and make the process mandatory.

Rule 203 - Locate and Delivery Requirements

Rule 203(b) of Regulation SHO replaced SRO "locate" rules (formerly contained in NASD Rule 3370 and NYSE Rule 440C) and created a uniform Commission requirement that a broker-dealer, before effecting a short sale in any equity security, have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the delivery date.

Rule 203(b)(3) of Regulation SHO also imposes obligations on broker-dealers that have extended failures to deliver in threshold securities.[8] Under Rule 203(b)(3), a participant of a registered clearing agency, such as a broker-dealer, is required to close out any fail to deliver position in a threshold security that has remained open for 13 consecutive settlement days by purchasing a security of like kind and quantity. Until the position is closed out, the broker or dealer and any broker or dealer for which it clears transactions, *e.g.*, an introducing broker, may not effect further short sales in that threshold security without borrowing or entering into a bona fide agreement to borrow the security (known as the "pre-borrowing" requirement).[9]

While the consequences of a 13 day old fail are clear in the Rule, the determination of when a fail is 13 days old is not. Because the rule does not specify an aging methodology, at least three approaches are possible:[10]

1. Straight counting. Each day, a participant could simply determine the lowest continuous fail to deliver position ("LCF") over the immediately preceding 13 settlement days based upon end-of-day positions reported by NSCC. Individual increases or decreases in reported fail to deliver positions are ignored unless they affect the LCF. The LCF is the amount that would need to be purchased at the end of the 13th day (or the beginning of the 14th day). Any amount purchased is

7 *See* Responses to Frequently Asked Questions Concerning Regulation SHO, Division of Market Regulation at http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

8 *See* Key Points About Regulation SHO, Division of Market Regulation (Apr. 11, 2005), at http://www.sec.gov/spotlight/keyregshoissues.htm ("Key Points").

9 *See* Key Points, *supra* fn.8; *see also* WSJ Article, *supra* fn.1 which notes that since Reg SHO was implemented, the number of securities on the threshold list has fallen 16%.

10 Footnote 95 of the Adopting Release provided examples of the close out obligation in various scenarios. 69 FR at 48017 fn.95. Market participants apparently believe that the examples are ambiguous and could support any of the aging methodologies described below.

credited against the required close out amount to determine the net purchase obligation on a rolling 13 day basis.[11]

2. FIFO. A second approach is to use a "first in-first out" ("FIFO") methodology. Where a net reduction exists in the firm's end-of-day settlement position compared to the previous day's end-of-day position reported by NSCC, the firm applies the amount of the reduction to its oldest end-of-day fail position.[12] In contrast to the "straight counting" method above, (which operates solely on the end-of-day positions as reported by NSCC), FIFO operates on net increases and reductions in the end-of-day fail positions reported by NSCC.

3. LIFO. A third approach is to apply a net reduction in a participant's NSCC fail to deliver position compared with the prior day against the most recent increases in the firm's end-of-day fail to deliver positions, *i.e.*, a "last in-first out" methodology ("LIFO"). This process applies the reduction to the most recent net increase in end-of-day position first, and applies any excess sequentially to the next oldest net increase in end-of-day position. Accordingly, an aging end-of-day position is reduced only if all previous net increases have been reduced to zero. Similar to FIFO, LIFO does not age an end-of-day position reported by NSCC as such, but rather an end-of-day increase in the net fail to deliver position.

FAQ 5.8 & The Division's Choice of Methodology

Although no aging methodology is specified in Rule 203, the Example in FAQ 5.8 shows that the Division has selected a modified form of LIFO as the appropriate methodology. With a significant exception, an end-of-day net reduction in the NSCC fail to deliver position will be applied against the most recent net increase in the fail position, and any excess amount of the reduction will be applied against the next most recent net increase, and so on. The significant exception occurs when the firm incurs a close-out obligation under Rule 203(b)(3). When a participant makes a purchase to close-out a fail position on day 13, the trade will be reflected, presumably as a reduction in the firm's NSCC position, three settlement days later. The staff's methodology applies this reduction against the 13 day-old fail that triggered the purchase obligation, rather than against more recent fails. This can be seen in the chart accompanying the Example in FAQ 5.8. On day 16, there is a 5000 share reduction from the previous NSCC end-of-day position.[13] Using a pure LIFO methodology, the reduction would be first applied to the

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[11] Even this simple methodology shows a complicating factor that is present in all methodologies used for Rule 203(b)(3) purposes: while aging is based on settlement days, close-out purchases are given credit on trade date if effected on settlement days 11, 12, or 13 (or the beginning of day 14). *See* FAQ 5.7.

[12] A further variation on FIFO might be to age the underlying customer positions and close-out those positions that persist for 13 consecutive settlement days. FAQ 5.8, however, says that Rule 203(b)(3) operates on the firm level and not the customer level. ("[T]he participant must look to its total fails positions at NSCC and not to fails positions at the customer account level.")

[13] The staff's methodology assumes that the net reduction on day 16 is a result of the close-out purchase. However, this is not necessarily why the participant's position in the Example is reduced by 5000 shares on day

4700 share net increase that occurred on day 11. However, the staff's methodology applies the reduction to the oldest fail position, *i.e.*, the 5000 share position on day 1 (similar to a FIFO allocation).[14]

Impact of FAQ 5.8

The Example in FAQ 5.8 shows a firm with very few changes to its end-of-day settlement positions over the course of more than a month.[15] This should be contrasted with the frequency of changes that occur in the end-of-day positions of large firms that clear and settle a substantial volume of trades in an actively trading threshold security. Even this relatively simple example illustrates the complexity of the modified LIFO methodology.

FAQ 5.8 is written in a mandatory manner. Although it first states that a participant "may first apply the reduction [of its open fail position] to the most recent increase in its fail to deliver position reflected at NSC," the next sentence states that the application of any net reduction in the NSCC fail position "must [be done] in accordance with the methodology described in this Question 5.8." (Emphases added.) Therefore, in this FAQ, the Division has expressed its view that a modified LIFO methodology for aging of fails must be used for purposes of Rule 203(b)(3).

The introduction to the FAQs notes that they are "not rules, regulations, or statements of" the SEC. However, it is likely that SEC and SRO examination (and enforcement) staffs will apply the Division's methodology in assessing compliance with Regulation SHO. Indeed, in Information Memo 06-23 (April 10, 2006) New York Stock Exchange Member Firm Regulation noted the publication of FAQ 5.8 and stated that all member organizations are expected to fully implement the modified LIFO methodology by May 1, 2006.[16] On April 25, 2006, the NASD issued Notice to Members 06-18 (April 2006) expressing a similar position.[17]

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16. The various trades settling at the firm that day could result in a net reduction of 5000 shares without any close-out activity by the firm. It is also possible that all of the clearing firm's settlements that day could result in no change or even an increase in the end-of-day position despite a close-out purchase by the firm on day 13.

[14] The chart in the Example also illustrates the complication mentioned in fn.11 supra of giving trade date credit for close-out purchases. On day 13, the fail position reported by NSCC is 10,000 shares, and it is the same on day 14. The assumption in the chart is that the 5000 share "Participant's Close Out Requirement" on day 13 is immediately and completely satisfied by a purchase on that day, and reflected in the 5000 share reduction in the participant's position on day 16. However, just using the chart, one cannot discern why there is no close-out requirement on day 14: the end-of-day NSCC position of 10,000 shares appears to continue to include an aged fail of 5000 shares. What this demonstrates is that the participant must incorporate its trading records with its settlement reports to arrive at the net close-out obligation each day.

[15] The end-of-day position in the Example changes on only eight out of 26 days.

[16] The Securities and Exchange Commission Issues Guidance on Regulation SHO, NYSE Information Memo 06-23 (Apr. 10, 2006) available at http://www.nyse.com.

[17] *See* NASD Notice to Members 06-18 (April 2006) available at http://www.nasd.com.

Conclusion

The SEC staff has taken the position that broker-dealers subject to Rule 203(b)(3) of Regulation SHO must use the modified LIFO methodology to determine the age of their fail to deliver positions in threshold securities and to apply any net reduction in end-of-day fail positions to earlier net increases in fail positions. After May 1, 2006, firms may be found to be in violation of Rule 203(b)(3) if their fail to deliver positions are not timely closed out in accordance with the methodology prescribed in FAQ 5.8.

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If you have any questions concerning the foregoing or would like additional information, please contact Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), Michael S. Didiuk (202-303-1280, mdidiuk@willkie.com) or the attorney with whom you regularly work.

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